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18 December 2012

Manager
International Tax Integrity Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: transferpricing@treasury.gov.au

Dear Sir/ Madam

**SUBJECT: SUBMISSION ON THE MODERNISATION OF TRANSFER PRICING RULES EXPOSURE DRAFT LEGISLATION**

CPA Australia represents the diverse interests of more than 139,000 members in 114 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we make this submission in respect of the exposure draft legislation 'Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules' issued by Treasury on 22 November 2012.

Broadly, the exposure draft legislation proposes the insertion of a second tranche of proposed amendments concerning the application of transfer pricing provisions into the Income Tax Assessment Act (1997) (the ITAA (1997)) in lieu of the current transfer pricing provisions in Division 13 of the Income Tax Assessment Act (1936) (the ITAA (1936)).

**General comments**

The first stage of the transfer pricing reforms has resulted in the introduction of retrospective legislation applying (as an assessment power independent of Division 13) to dealings between related entities in countries with which Australia has signed a double tax agreement.

This legislation received Royal Assent on 8 September 2012 and has now been inserted into the ITAA (1997) as Subdivision 815-A.

Subdivision 815-A has retrospective effect (from 1 July 2004) but will have no prospective operation from the date of application of the new changes. The latest Exposure Draft legislation comprises the introduction of proposed Subdivisions 815-B, 815-C, 815-D and 815-E into the ITAA (1997). As a corollary Division 13 of the ITAA (1936) will be repealed when the proposed provisions are enacted.

The Explanatory Memorandum (EM) to the exposure draft legislation indicates that the objective of proposed Subdivisions 815-B and 815-C is to ensure that the Australian tax outcomes for an entity accord with the application of the arm's length principle consistent with the transfer pricing articles in Australia's tax treaties and internationally accepted guidance on their interpretation.

Our overriding concern with the draft legislation is that it will create additional compliance costs for taxpayers and uncertainty about what taxpayers need to be doing differently to ensure they are complying with the revised transfer pricing rules.

We therefore strongly recommend the introduction of a range of safe harbours or administrative concessions for SME taxpayers, and those with a low level of transactions, to minimise the significant additional compliance burden that will otherwise be imposed on these taxpayers. In our view, the revenue risk posed by SME taxpayers under the proposed transfer pricing regime, especially those operating in the smaller end of

the market, does not justify the significant increase in compliance costs borne by such entities if the proposed measures are not enacted without providing such taxpayers with appropriate relief.

**Specific comments**

Our comments relating to specific aspects of the exposure draft legislation are provided below.

**1. Documentation and penalties**

Proposed subdivision 815-D contains rules for contemporaneous transfer pricing documentation. This documentation is ‘necessary but not sufficient’ for a taxpayer to be able to establish a reasonably arguable position (RAP) and therefore links contemporaneous documentation to the current transfer pricing penalty regime. The provisions apply a de minimis rule to provide relief from penalties if the ‘tax shortfall’ arising from a transfer pricing adjustment is less than the greater of $10,000 or 1% of income tax payable by the taxpayer for the relevant tax year.

The proposed de minimis rule is grossly inadequate as it effectively applies to tax shortfalls which comprise 1% of a taxpayer’s income tax payable. For multinational enterprises, including SME taxpayers, transfer pricing issues often relate to a significant part of the business with the associated tax liability also comprising a significant part of the total tax liability. The vast majority of taxpayers will therefore not qualify for this penalty ‘concession’.

We recommend an exemption from penalties where a taxpayer’s transactions with international related parties fall below a certain dollar threshold. At a minimum, this threshold should align with the current $2 million international related party threshold which must be met before taxpayers are required to complete and lodge an International Dealings Schedule with their income tax returns.

**2. Safe harbours /administrative practices**

As discussed, we are concerned that the exposure draft legislation will create unnecessary compliance costs for taxpayers, particularly those in the SME market.

We are strongly of the view that a de minimis threshold or safe harbour exempting taxpayers from the need to prepare documentation, and the risk of incurring associated penalties in the absence of a RAP, should be specifically incorporated into the proposed legislation.

In addition, the legislation should be amended to specifically preserve the current administrative concession available for intra-group services which many taxpayers currently rely on in minimising their transfer pricing compliance costs. Moreover, we believe that there should be an uplift in the value of the $500,000 de minimis exemption currently available under Taxation Ruling TR1999/1 as that threshold has not been increased since the issue of that ruling on 22 January 1999.

**3. Self-assessment**

The proposed provisions in Subdivisions 815-B and 815-C are self-executing in their operation. This will bring the rules in line with the design of Australia’s taxation system which generally operates on a self-assessment basis. Taxpayers will therefore need to assess their own transfer pricing arrangements to determine whether they comply with the new rules. However, the proposed provisions only authorise increases in tax outcomes.

We believe the one-sided application of the new provisions is inconsistent with both a self-assessment environment and the objective of the transfer pricing provisions which is to reflect arm’s length outcomes. We recommend the legislation be redrafted to allow a taxpayer to downward assess a tax liability where that reflects arm’s length outcomes.

**4. Characterisation of adjustments**

We are concerned about the potential for proposed Subdivision 815-B to operate unreasonably by allowing the Commissioner of Taxation to make an adjustment to negate a transfer pricing benefit without attributing that adjustment to any particular amount of income or expense. In this regard, we note that Subdivision 815-B does not contain an equivalent to section 815-30(2) of Subdivision 815-A, which requires the Commissioner to attribute an adjustment to a particular income or expense amount.

We recommend a similar provision to section 815-30(2) be inserted into Subdivision 815-B so as to avoid potential adverse implications for customs duty and the use of Mutual Agreement Procedures under Australia's double tax treaties.

### 5. Reconstruction

It is clear from paragraphs 2.87 to 2.91 of the EM that paragraphs (5) to (8) of section 815-125 authorise the Commissioner of Taxation to reconstruct or re-characterise transactions.

Paragraphs 1.64 to 1.68 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 state that reconstruction of transactions should only occur in 'exceptional cases' and prescribe two 'exceptional circumstances' in which it may be appropriate to do so.

There is no similar restrictive wording found in proposed section 815-125 or in the accompanying EM. Our concern is that these provisions therefore provide the Commissioner with a much wider power than that envisaged by the OECD Guidelines, and that the Commissioner will seek to use proposed section 815-125 to reconstruct or re-characterise actual arrangements in cases or circumstances that are outside those contemplated by the OECD Guidelines.

We recommend the specific provisions in Section 815-125 be deleted. They are not necessary or appropriate given the guidance already provided in the OECD Guidelines on these matters.

### 6. Modification of thin capitalisation

Proposed section 815-135 contains specific provisions dealing with the interaction of the transfer pricing rules and thin capitalisation rules in Division 820 of the ITAA (1997). Like the existing provisions in Subdivision 815-A, the intention of these provisions is to maintain the position outlined by the Commissioner in Taxation Ruling TR 2010/7. That is, that where the Commissioner of Taxation considers a safe harbour amount of debt is not an arm's length amount, the interest rate on that debt will be calculated having regard to the arm's length amount of debt (not the actual amount of debt).

This provision places an onerous obligation on all taxpayers to determine the amount of debt that would have been borrowed at arm's length in order to identify an arm's length interest rate to apply to the debt.

At the very least, we recommend that a safe harbour for SME taxpayers be introduced that exempts them from having to comply with this provision where their loan values are below a certain amount.

For example, the current $250,000 debt deduction de minimis exemption under the thin capitalisation rules pursuant to section 820-35 of the ITAA (1997), could be extended to apply to SME taxpayers so that they would not need to identify an arm's length interest rate where total debt deductions were similarly below the above $250,000 threshold. In our view such a measure would not impose a high compliance cost and would not be a substantial cost to revenue given the current availability of the exemption under section 820-35.

### 7. Amendment of assessments

Proposed sections 815-145 and 815-235 provide for an 8 year time limit for amending assessments to give effect to sections 815-115 and 815-215 respectively.

Whilst we welcome the change from the current unlimited time period for amendments to give effect to Division 13, we consider that the general 4 year time limit in section 170 of the ITAA (1936) is more appropriate. We believe that, given the introduction of self-assessment and contemporaneous documentation requirements under the new provisions, along with expanded disclosure requirements in the International Dealings Schedule and the Reportable Tax Position Schedule, there is no longer a case for different time limits for transfer pricing and other tax amendments.

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

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